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The FoxMeyer Drugs' Bankruptcy: Was it a Failure of ERP?

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Abstract

This interpretive case study of FoxMeyer Drugs' ERP implementation is based on empirical frameworks and models of software project risks and project escalation. Implications of the study offer suggestions on how to avoid ERP failure.

Introduction

FoxMeyer Drugs was a \$5 billion company and the nation's fourth largest distributor of pharmaceuticals before the fiasco. With the goal of using technology to increase efficiency, the Delta III project began in 1993. FoxMeyer conducted market research and product evaluation and purchased SAP R/3 in December of that year. FoxMeyer also purchased warehouse-automation from a vendor called Pinnacle, and chose Andersen Consulting to integrate and implement the two systems. Implementation of the Delta III project took place during 1994 and 1995.

According to Christopher Cole, chief operating officer at Pinnacle, the FoxMeyer mess was "not a failure of automation. It was not a failure of commercial software per se. It was a management failure" (Jesitus, 1997). Perhaps management had unrealistic expectations. Did management expect technology to be a "magic bullet"? (Markus and Benjamin 1997a, 1997b). In reality, it was the opposite. FoxMeyer was driven to bankruptcy in 1996, and the trustee of FoxMeyer announced in 1998 that he is suing SAP, the ERP vendor, as well as Andersen Consulting, its SAP integrator, for \$500 million each (Caldwell 1998, Stein 1998).

Project Risks

The Delta III project at FoxMeyer Drugs was at risk for several reasons. Using a framework developed for identifying software project risks (Keil, Cule, Lyytinen and Schmidt 1998), this study classifies the project risks at FoxMeyer into (1) customer mandate, (2) scope and requirements, (3) execution and (4) environment.

First, the customer mandate relies on commitment from both top management and users. At FoxMeyer, although senior management commitment was high, reports reveal that some users were not as committed. In fact, there was a definite morale problem among the warehouse employees. This was not surprising, since the project's Pinnacle warehouse automation integrated with SAP R/3 threatened their jobs. With the closing of three

warehouses, the transition to the first automated warehouse was a disaster. Disgruntled workers damaged inventory, and orders were not filled, and mistakes occurred as the new system struggled with the volume of transactions. \$34 million worth of inventory were lost (Jesitus 1997).

Second, the scope of the project was risky. FoxMeyer was an early adopter of SAP R/3. After the project began, FoxMeyer signed a large contract to supply University HealthSystem Consortium (UHC). This event exacerbated the need for an unprecedented volume of R/3 transactions. Although, prior to the contract, testing seemed to indicate that R/3 on HP9000 servers would be able to cope with the volume of transactions, in 1994 R/3 could process only 10,000 customer orders per night, compared with 420,000 under FoxMeyer's original mainframe system (Jesitus 1997).

Third, the execution of the project was an issue due to the shortage of skilled and knowledgeable personnel. FoxMeyer did not have the necessary skills in-house and was relying on Andersen Consulting to implement R/3 and integrate the ERP with an automated warehouse system from Pinnacle. Although at the height of the project there were over 50 consultants at FoxMeyer, many of them were inexperienced and turnover was high (Computergram International 1998).

Finally, the environment quadrant of the risk framework includes issues over which project management has little or no control (Keil, Cule, Lyytinen and Schmidt 1998). Although FoxMeyer must have realized the project was in trouble, its perceived dependence on consultants and vendors prevented it from seeing how it could gain control. Since FoxMeyer was competing on price, it needed a high volume of transactions to be profitable. Yet with the UHC contract "the focus of the project dramatically changed", contributing to rising project costs (eventually over \$100 million), lowering FoxMeyer's already narrow margins and erasing its profitability.

Given the high level of risk, why did FoxMeyer initiate the project? Furthermore, why was the project allowed to escalate to the extent of contributing to FoxMeyer's bankruptcy?

Project Escalation

FoxMeyer's mainframe systems were becoming inadequate for its growing volume of business. Moreover,

its Unisys system was being phased out by the vendor and needed to be replaced. The Delta project was envisaged as a client/server R/3 solution integrated with automated warehouses to accommodate future company growth. A model of factors that promote project escalation suggests that (1) project factors, (2) psychological factors, (3) social factors and (4) organizational factors all contributed to the continuation of the project despite negative information (Keil 1995).

The implementation appeared troubled almost from the start. Despite warnings from Woltz Consulting, during the early stages of the project, that a schedule for the entire implementation to be completed in 18 months was totally unrealistic, FoxMeyer's Delta project went ahead (Jesitus 1997).

Project factors

Escalation is more likely when there is perceived evidence that continued investment could produce a large payoff. FoxMeyer expected the Delta project to save \$40 million annually. Andersen Consulting and SAP were also motivated to continue the project. According to FoxMeyer, Andersen used trainees (Caldwell 1998) and used the Delta project as a "training ground" for "consultants who were very inexperienced" (Computergram International 1998). Similarly, FoxMeyer claimed that SAP treated it like "its own research and development guinea pig" (Financial Times 1998). Furthermore, project setbacks appeared temporary. For example, there was some measurement evidence that these systems could perform at FoxMeyer's required volume of transactions.

Psychological factors

Andersen and SAP had a prior history of success that encouraged them to continue the project. Andersen stated "we delivered an effective system, just as we have for thousands of other clients" (Computergram International 1998). FoxMeyer CIO Robert Brown felt a high degree of personal responsibility saying, "We are betting our company on this." (Cafasso 1994). Moreover, he expressed his emotional attachment to the project when he boasted about how an integrated \$65 million computer system built on SAP R/3 would radically improve the company's critical operations. However, FoxMeyer overspent and bit off more than they could chew, since they lacked available users on staff with the sophistication to handle a fast-track installation. Also, the decision to go with two different vendors for two of the company's most important business systems was "an error in information processing" (Keil 1995). This added still greater complexity to an already challenging situation (Jesitus 1997).

Social factors

It is likely that Andersen Consulting and SAP needed to externally justify the Delta project. They probably did not consider de-escalating the project since abandonment would not be good publicity. Moreover their "norms for consistency" (Keil 1995) were such that perseverance with project problems usually paid off for them.

Organizational factors

Both FoxMeyer's CEO and CIO were strong advocates of the project. However in February 1996, Thomas Anderson, FoxMeyer Health's president and CEO (and champion of the company's integration /warehouse-automation projects) was asked to resign due to delays in the new warehouse and realizing the SAP system's projected savings. A change in management is often needed for de-escalation (Montealegre and Keil 1998). But it was too late for FoxMeyer.

Reports seem to indicate that FoxMeyer had loose management controls, shown by the fact that management did not control the scope of the Delta project. For example, originally, FoxMeyer expected Andersen to design a system that could "ship in X number of hours". Although Andersen designed a system that could do that, FoxMeyer later, wanted to be able to ship in one-third to one-half that time (Jesitus 1997). Also, with the UHC contract, the throughput capacity of the SAP project had to be increased substantially. Furthermore, FoxMeyer did not have adequate change management policies and procedures. For example, its labor problems exploded when workers began leaving their jobs en masse from three Ohio warehouses, which were scheduled to be replaced by the automated Washington Court House center. Because of a "debilitating morale problem among departing workers, a lot of merchandise was dumped into trucks and arrived at Washington Court House with packages damaged or broken open or otherwise unsalable as new product, [resulting in] a huge shrinkage in inventory" (Jesitus 1997).

Implications

There are high risks involved when adopting new technologies, especially in a unique situation that vendors cannot adequately test prior to actual use. On the other hand, customers should be aware of the risks and be compensated with discounts or other incentives for early adoption. FoxMeyer should have realized the risk in adopting R/3 in its early years and negotiated with the consultants to share the project risks by tying their compensation to project results. The contract with the consultants should have specified experienced personnel by name and no billing for "rookies". Also, FoxMeyer should have made an effort to become less dependent on

the consultants. For example, knowledge transfer should have been written into the consulting contract. FoxMeyer needed to ensure that project knowledge was transferred to them from the consultants so that they could develop in-house skills for maintenance of the system after the consultants had left.

In hindsight, it is obvious that FoxMeyer should not have "bet the company" (Cafasso 1994) and should have de-escalated the project. To do that, it could have reduced the scope of the project (Montealegre and Keil 1998) - perhaps foregoing the UHC contract, or postponing it to a later phase in the project. A phased implementation would have been less risky and would have given the implementation team a chance to test transaction throughput more thoroughly. The pre-implementation testing was inadequate, partly because the UHC contract was added afterwards. Also, if FoxMeyer had not reduced their prices as much, then they would not have been as dependent on such a high volume of transactions. In other words, FoxMeyer should have reengineered its business practices to be compatible with the capabilities of the technology at that time. Using just one vendor in the first phase would have reduced the risks and complexity of the project. The warehouse automation multiplied the project risk and interactions between R/3 and Pinnacle's automation took FoxMeyer into uncharted waters. Control of the project scope, costs and progress should have been tighter. An objective audit of the project progress might have saved FoxMeyer. Finally, FoxMeyer should have avoided the morale problem in the warehouses by training the employees, helping them develop new skills, putting some of them on the implementation team and using other change management techniques.

Although a lack of management commitment can result in project failure, management over-commitment can be even more disastrous. It can cause errors in judgment and lead to project escalation. Overall, the expected payoff from the Delta III project was probably overestimated, given that benefits are often intangible. But regardless of expectations, for FoxMeyer it was not worth taking the risks it did. In conclusion, FoxMeyer's experiences provide valuable lessons on how to avoid ERP failure.

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